

Section 23701 is amended to read:

§ 23701. Exemption from Taxation.

(a)(1) In General ~~—Section~~Revenue and Taxation Code section 23701 provides an exemption from franchise or ~~corporation~~corporate income tax for organizations organized and operated for nonprofit purposes within the provisions of a specific section of Article 1, Chapter 4, or are subject to ~~Section~~Revenue and Taxation Code sections 23701h or 23701x (relating to certain title-holding companies), if:

(A) An application for exemption is submitted in the form prescribed by the Franchise Tax Board; ~~and~~

(B) A filing fee of twenty-five dollars (\$25) is paid with each application for exemption filed with the Franchise Tax Board after June 30, 1983; and

(C) The Franchise Tax Board issues a determination exempting the organization from tax.

(2) ~~However, t~~The exemption provided does not extend to the unrelated business taxable income of such organization (see ~~Section~~Revenue and Taxation Code section 23731). Also the exemption is not applicable to an organization determined to be a feeder organization under ~~Section~~Revenue and Taxation Code section 23702. An organization which has been determined to be exempt by the ~~department~~Franchise Tax Board can rely upon such determination so long as there are no substantial changes in the law or the organization's charter, purposes or method of operation. However, to retain exempt status the organization must elect an annual accounting period, must submit an annual return or statement, and pay appropriate filing fees.

(3) Notwithstanding anything to the contrary in this regulation, for requests filed on or after January 1, 2008, an organization that is exempt from federal income tax under Internal Revenue Code section 501(c)(3) shall, upon submission of a copy of its federal determination letter to the Franchise Tax Board with the Form FTB 3500A, be exempt from franchise or corporate income tax under Part 11 of Division 2 of the Revenue and Taxation Code, except to the extent noted in the preceding paragraph, under the authority of Revenue and Taxation Code section 23701d, subdivision (c). The additional filing requirements specified in subsection (b) shall not apply to any organization described in this paragraph.

(b) **Proof of Exemption.** An organization must be organized (chartered, incorporated) and operated (conducting activities) primarily (in some cases exclusively) for one or more of the purposes specified in the particular section describing the exempt organization. If the organization fails to meet the organizational or operational test for the particular section describing the exempt organization, it is not entitled to exemption.

(1) ~~An~~ Except as provided in subsection (a)(3), an organization claiming exemption under ~~Section~~ Revenue and Taxation Code section 23701 and described in ~~Section~~ Revenue and Taxation Code sections 23701a through 23701z shall file with the Franchise Tax Board an exemption application (Form FTB 3500) filled out in accordance with the instructions on the form or issued therewith. The exemption application and the attachments thereto shall show the character of the organization, the purpose for which it was organized, its actual and proposed activities, the sources of its income and the receipts and disposition thereof, whether or not any of its income or receipts is credited to surplus or may inure to the benefit of any private shareholder or individual, and in general all facts relating to its operations which may affect its right to exemption. To each application there shall be attached a copy of the articles of incorporation, declaration of trust or other organizational document, the bylaws or other code of regulations, and financial statements showing assets, liabilities, receipts and disbursements (actual or as proposed) of the organization. The organizational document must meet the organizational test set out below and the activities or proposed activities must meet the operational test.

(A) Inurement of Income to Member or Individual. Sufficient information must be furnished about benefits and compensation to be received by members, officers, directors and employees to insure that it can be said they will not receive personal or private inurement. An organization is not operated for one or more exempt purposes contained in ~~Section~~ Revenue and Taxation Code sections 23701a through 23701z ~~of the Revenue and Taxation Code~~ (with some exceptions discussed below) if net earnings inure directly or indirectly in whole or in part to the personal or private benefit of a member, officer, director, employee or individual.

Inurement means that an individual receives some special benefit which is unreasonable under the circumstances because of his membership or relationship to the organization. Where organizations, exempt under ~~Section~~ Revenue and Taxation Code sections 23701d or 23701n are involved, the activity that leads to inurement may also be a prohibited transaction under ~~Section~~ Revenue and Taxation Code section 23736.1 ~~of the Code~~. If the organization is a private foundation, the violation of the prohibitions upon self-dealing set forth in the Internal Revenue Code would normally constitute inurement if not corrected.

1. Under ~~Sections~~ Revenue and Taxation Code sections 23701a, 23701b, 23701i, 23701j, 23701n and 23701s the payment of sick, accident, death, unemployment or retirement benefits out of employer, employee or member contributions does not result in personal or private inurement. In most cases, a limited amount of income, which may be taxable as unrelated business income, may be used for the payment of permitted benefits. Local associations of employees may receive contributions from employers that benefit employees without loss of exempt status. Payment of profits to participants of exempt diversified management corporations are also permissible benefits.

2. Inurement has been held to have occurred in many situations, including the following:

(I) Unreasonable compensation for services. The facts and circumstances of each case must be examined to determine if the compensation is unreasonable.

(II) Unreasonable rental charges.

(III) Unsecured loans of doubtful safety.

(IV) Deferred or retained interest in the assets of an organization claiming exemption under Section Revenue and Taxation Code sections 23701c, 23701d, 23701f, or 23701r.

(V) Operation of an organization to serve private interests.

(VI) Self-dealing with the organization; such as, making sales to or purchases from the organization which are not reasonable on their face.

(VII) Lack of a reasonable return on the capital of an organization exempt under Section Revenue and Taxation Code section 23701d.

(VIII) Use of the organization's property without adequate payment.

(IX) Reduction of dues, increase in assets, or provision of more services to members for the same dues which occurs as a result of a social and recreational organization's receiving income from the general public may be inurement to members. Use of limited income received from the general public for the above purposes may be permissible if it is taxable as unrelated business income.

(X) Reimbursement of founder for expenses incurred in connection with organization before it was exempt.

(XI) Payment of part of the general operating expenses of a membership organization out of income received from the general public normally results in inurement.

(B) Change of exempt classification.

1. An organization requesting a change of exempt status more than one year after exemption has been granted must submit a new exemption application, unless clause 2. is applicable. However, supporting information that is still current need not be resubmitted.

2. If an initial federal exemption application is timely filed and the exempt classification when received is different than that issued by the Franchise Tax

Board, a change of classification will be considered without a formal application if: the request for reclassification is submitted within ninety days after issuance of the federal exemption letter. The request shall be accompanied by a copy of the federal determination letter and any supporting information not previously furnished the Franchise Tax Board.

(2) In addition to the information specifically required under this regulation, the Franchise Tax Board may require additional information as deemed necessary to determine whether an organization is entitled to exemption under Section Revenue and Taxation Code section 23701, including evidence that the organization has established exempt status with the Internal Revenue Service.

(3) An organization applying for exemption from tax or for a change (reclassification) of exempt status must pay an application fee of \$25 with the exemption application. However, exceptions to the payment of the fee may be made for unincorporated chapters of groupssubordinates (processed on a group basis) and for unincorporated associations or trusts operating in California which were exempt from federal taxation prior to January 1, 1970. A copy of the Internal Revenue Service exempt determination letter should be furnished with the application.

(4) Retroactivity of Exemption. Exempt status may be granted for years prior to approval of the exemption application but only to the extent the organization establishes it satisfied the exemption requirements during each of such prior years. In no event shall a claim for refund be allowed unless timely filed under Section Revenue and Taxation Code section 19306. In the case of exemptions granted under subsection (a)(3), the effective date of an organization's tax-exempt status for California franchise or income tax purposes shall be no later than the effective date of the organization's tax-exempt status, under Section 501(c)(3) of the Internal Revenue Code, for federal income tax purposes.

(c) Organizational Test.

(1) In General.

(A) An organization is organized primarily (in some cases exclusively) for one or more exempt purposes only if its articles of organization ("articles") as defined in paragraph (2) of this subdivisionsubsection:

1. Expressly set out an exempt purpose consistent with the purposes stated in the section which describes the exempt organization; and
2. Limit any other purposes or powers of the organization, except to an insubstantial degree, to those in furtherance of the purpose.
3. In the case of an unincorporated association (that is not a trust), expressly state that the organization is organized for nonprofit purposes and that individuals will not profit therefrom. However, associations described in

~~Section~~Revenue and Taxation Code sections 23701h or 23701x (relating to certain title-holding companies) are not subject to this requirement.

4. In the case of a domestic corporation, incorporate the organization under Division 2, Parts 1, 2, 3, 4 or 6, of the California Corporations Code. However, incorporation under other provisions of the Corporations Code is permitted to the extent provided in ~~Sections~~Revenue and Taxation Code sections 23701h and 23701x (relating to certain title-holding companies).

(B) In meeting the organizational test, the organization's specific purpose, may be as broad as, or more specific than, the purposes stated in the section which describes the exempt organization. The purpose should normally be accomplished by the primary activity of the organization.

(C) An organization is not organized primarily for one or more exempt purposes if its articles expressly empower it to carry on, other~~wise~~ than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in a section describing an exempt organization. Thus, an organization that is empowered by its articles "to engage in a manufacturing business," or "to engage in the operation of a social club" does not meet the organizational test of an organization desiring exemption under ~~Section~~Revenue and Taxation Code section 23701d regardless of the fact that its articles may state that such organization is created "for charitable purposes" within the meaning of ~~Section~~Revenue and Taxation Code section 23701d.

(2) Articles of Organization. For the purposes of this section, the term "articles of organization" or "articles" includes the trust instrument, the corporate charter, the articles of association, or any other written instrument by which the organization is created.

(3) If before January 1, 1970, an organization has been determined to be an exempt organization by the Franchise Tax Board, the fact that such organization does not meet the organizational test prescribed by this paragraph shall not be a basis for revoking such determination.

(d) Operational Test.

(1) Primary Activities. An organization will be regarded as "operated primarily" or "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in the section (Revenue and Taxation Code sections 23701a through 23701z) which describes the exempt organization. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

(2) Exempt status will be recognized in advance of operations (or incorporation), where proposed operations are planned to begin within one year and can be described in sufficient

detail to permit a conclusion that the organization will clearly meet the particular requirements of the section under which exemption is claimed. A mere restatement of purposes or a statement that proposed activities will be in furtherance of such purposes will not satisfy these requirements. The organization must fully describe the activities in which it expects to engage, including the standards, criteria, procedures, or other means adopted or planned for carrying out the activities; the anticipated source of receipts, and the nature of contemplated expenditures. Where the Franchise Tax Board considers it warranted, a record of actual operations may be required before a determination letter will be issued.

(A) Where exempt operations do not actually begin within the year, an attachment should be added to the annual report to explain the delay and to outline plans for conducting activities during the next year. Failure to explain such inactivity will be cause for revocation of the exempt status since an inactive organization is not operated for exempt purposes and therefore is not entitled to exemption from tax.

(B) Organizations that commence exempt operations and later become inactive are subject to loss of exempt status unless they include an attachment on their annual report to explain that their inactivity is temporary and to outline their plans for becoming active in the near future.

(e) The words "private shareholder or individual" in ~~Sections~~[Revenue and Taxation Code sections](#) 23701a through 23701z refer to persons having a personal or private interest in the activities of the organization.

(f) Every organization which has established its right to exemption shall submit an annual report or statement as required by ~~Sections~~[Revenue and Taxation Code section](#) 23772. Also, the organization shall maintain adequate operational and financial records to show that its operations are conducted in an exempt manner. Changes in the character, operations or purposes of an exempt organization shall be reported in writing to the Franchise Tax Board for evaluation as to whether the organization's exempt status is affected. In cases where the organization's exempt status is revoked, either by suspension of corporate powers, ~~or~~ for failure to elect an accounting period, or to file an annual return or statement, ~~then (see Sections~~[Revenue and Taxation Code sections](#) 23776 and 23778 [are applicable](#) for reinstatement provisions).

(g) Every exempt organization shall make its records available or shall submit, in addition to its annual information return or statement, such additional information as may be required by the Franchise Tax Board for the purpose of enabling it to inquire further into the organization's exempt status and to administer the provisions of Chapter 4 of the ~~Bank and~~ Corporation Tax Law.

(h) **Withdrawal of Applications.** Applications for exemption may be withdrawn, upon the written request of one of the principal organizers or his/her attorney, at any time prior to the issuance of a determination letter. However, even though the application is withdrawn, the application, supporting documents and the application fee will be retained by the Franchise Tax Board and will not be returned to the organization.

(i) Group Exemptions for ~~Unincorporated Subordinates Chapters~~.

(1) A central organization (one which has one or more California subordinates under its general supervision or control) may apply for exemption for itself and ~~its unincorporated~~ subordinates (chapter, local, post or unit). A central organization may be a subordinate itself; for example, a state organization which has subordinate units and may itself be affiliated with a national organization or a district of a state organization. This procedure will relieve each of the subordinates ~~unincorporated chapters~~ from applying separately for exemption.

(2) The organization applying for a group exemption letter must establish its own exempt status. It must also establish that the ~~unincorporated~~ subordinates to be included in the group are:

(A) Affiliated with it;

(B) Subject to its general supervision and control; and

(C) Exempt under the same lettered section under ~~Section~~ Revenue and Taxation Code section 23701, including organizations exempt under subsection (a)(3),

although not necessarily exempt under the same section as the national, state or parent (central) organization.

(3) Each subordinate to be included in the exempt determination must be formed under a standard constitution, articles of association, articles of incorporation or bylaws, and must authorize the central organization in writing to include it in the group exemption letter.

(4) A central organization seeking a group exemption letter for its subordinates must establish its own exemption separately by filing an exemption application form. In addition to the information required to establish its own exemption or information not previously furnished, if it is already exempt, it must include in the application for group exemption:

(A) Information verifying the existence of the relationships set out in ~~paragraph~~ subsection (2)(A) and (B) above.

(B) A description of the principal purposes and activities of subordinates.

(C) A sample copy of the uniform governing instrument for subordinates.

(D) An affirmation to the effect that, to the best of the central organization's knowledge, the subordinates are operating in accordance with the stated purposes.

(E) A statement that each subordinate to be included in the group exemption letter has furnished written authorization to the parent organization.

(F) A list of all California subordinates, mailing addresses and corporation numbers or Franchise Tax Board organization numbers if assigned. If an annual group report will be submitted, the organizations to be included in the report should be identified.



~~Each subordinate that cannot be included in the annual information group report or statement must be assigned an organization number by the Franchise Tax Board if it is not incorporated or qualified to do business in California.~~

(5) Information required annually to maintain a group exemption letter. The national, central or state organization must submit to the Franchise Tax Board annually within 45 days after the close of the annual accounting period of its subordinates ~~chapters, to the Franchise Tax Board, attention:~~

(A) Information regarding all changes in the purpose, character, or method of operation of subordinates included in the group exemption letter.

(B) A complete listing, with addresses, of all active California ~~chapters~~ subordinates, showing the corporation or organization number assigned by ~~this department the~~ Franchise Tax Board (when one has been assigned). If a group report will be submitted, the listings should indicate all subordinates that are authorized to and will be included in the group report. The list should be marked to indicate which subordinates have changed their names or addresses during the year. Any new subordinate formed during the year shall be clearly identified.

(C) A separate listing should show all subordinates that have ceased to exist since the last report and those that have disaffiliated from the central organization.

(D) Each subordinate must be included in an information return or statement submitted annually. Subordinates that meet the requirements may be included in a group report, while any subordinate not authorized and not included in the group return must submit an individual return or statement.

(E) Submission of the above information does not relieve the central organization or any of its subordinates of the duty to submit such additional information as the Franchise Tax Board may require to permit it to determine whether the conditions for continued exemption are met.

(6) Termination of a group exemption letter.

(A) Termination of a group exemption letter will result in nonrecognition of the exempt status of all included subordinates. To reestablish an exempt status in such cases, each subordinate must file an exemption application or a new group exemption must be applied for and secured.

(B) If a central or state organization covered by a group exemption letter ceases to exist, the group exemption letter will be terminated.

(C) Failure of the central or state organization to submit an annual listing or information return for itself (where required) and for its subordinates which are



included in the group letter and designated to be included in a group report may result in termination of the group exemption letter.

(D) If a subordinate which is covered by the group letter and which is required to report separately to the Franchise Tax Board does not submit an annual report, its exempt status may be terminated on an individual basis. The group exemption letter will no longer be applicable to such subordinate, but will otherwise remain in effect. Where a subordinate's exemption is terminated on an individual basis, it must reapply for exemption on an individual basis.

~~(7) — Unincorporated associations that are covered by a group letter that later incorporate or new chapters of such groups that form corporations must submit an individual application with fee to establish exempt status. However, in such cases the exemption application can be abbreviated as indicated in the instructions to Form 3500.~~

Note: Authority cited: Section 19503, Revenue and Taxation Code.  
Reference: Section 23701, Revenue and Taxation Code.